

ATTACHMENT A

to

Comments of Western Wireless

in

**FEDERAL-STATE JOINT BOARD ON UNIVERSAL
SERVICE SEEKS COMMENT ON CERTAIN OF THE
COMMISSION'S RULES RELATING TO HIGH-COST
UNIVERSAL SERVICE SUPPORT AND THE ETC
DESIGNATION PROCESS**

CC Docket No. 96-45

May 5, 2003

***The Legal and Historical Background of the
Federal Universal Service System***

Prepared by

Hogan & Hartson L.L.P.

Prepared on behalf of:

Western Wireless Corporation
Gene DeJordy, Vice President of Regulatory Affairs
Jim Blundell, Director of External Affairs
Mark Rubin, Director of Federal Government Affairs
3650 131st Avenue SE, Suite 400
Bellevue, Washington 98006
425-586-8700

May 5, 2003

The Legal and Historical Background of the Federal Universal Service System

By Hogan & Hartson L.L.P.

I. Introduction

This paper discusses the major federal developments in the establishment and evolution of universal telephone service in the United States. It then discusses the effect that several recent FCC orders have had on universal service and the growth of the universal service fund ("USF").

II. Legal History of Universal Service

A. Universal Service Before 1996

Prior to the passage of the Telecommunications Act of 1996, the universal service system consisted of a variety of implicit and explicit subsidies through which higher-cost services were funded by charging more for other services. The most important of the implicit subsidies were built into the access charge system, under which interexchange carriers ("IXCs") pay for access to incumbent local exchange carriers' ("ILECs") networks.¹ The FCC instituted access charges in 1983, after the AT&T divestiture, because local phone companies were no longer able to recoup losses for local service, which were priced below cost, by pricing long distance calls above cost.² Thus under the access charge system, LECs charged IXCs access charges that were significantly above cost in order to pay for the provision of local service.³

In addition to intercarrier subsidies built into access charges, regulators required ILECs to maintain internal cross-subsidies to fund higher-cost services. Under the concept of geographic rate averaging, ILECs charge comparable rates for service to urban and rural customers, even though costs are lower in urban areas.⁴ Thus urban service effectively subsidizes rural service. ILECs similarly charge more for business service in order to subsidize residential service.⁵

The Commission also instituted several explicit subsidies for universal service. The federal High-Cost Loop Fund and the Long-Term Support ("LTS") mechanism provided assistance to ILECs with higher-than-average embedded loop costs.⁶ The Commission's Dial Equipment Minute ("DEM") weighting program (later renamed Local Switching Support) helped subsidize rural ILECs' embedded switching costs.⁷ In addition to these high-cost service subsidies, the Commission

also established the Lifeline Assistance and Link Up America programs, which supported telephone service for low-income customers.⁸

These pre-1996 Act explicit mechanisms were slightly reformulated in 1997, so that a competitively neutral mechanism, rather than access charges or other implicit cross-subsidies, supplies the funding. In large part, however, these pre-1996 Act subsidy mechanisms remain in place to this day.

B. Universal Service Since 1996

The 1996 Act introduced dramatic changes to the existing universal service system. In the Act, Congress codified the concept of universal service for the first time, directing the Commission to preserve and advance universal service while also promoting competition for local telephone service. Section 254 outlines the basic principles of universal service: “equitable and nondiscriminatory” contributions to the fund; “specific, predictable, and sufficient” support for high-cost services; support for schools, libraries, and rural healthcare; and the roles of the Federal-State Joint Board and the state commissions.⁹ Section 214(e) of the Act delineates the process through which a carrier may receive ETC designation from a state commission. It lays out ETCs’ obligations with respect to services provided and use of universal service support.

Since 1997, the FCC and the courts have issued a number of key decisions establishing a more competitively neutral universal service funding system and reaffirming that universal service and local competition are not mutually exclusive policy objectives. The major steps in this evolution are described here, including both FCC and court decisions. While many of the decisions address overlapping issues, for ease of exposition the discussion below groups the decisions subsequent to the 1997 *Universal Service First Report and Order* into three categories: decisions relating to ETC designation and portability; decisions relating to funding levels in areas served by non-rural carriers; and decisions relating to funding levels in areas served by rural telephone companies.

1. 1997 *First Report and Order*

The *Universal Service First Report and Order* was the FCC’s initial comprehensive order on universal service. It established the important principle of competitive neutrality: that is, “universal service support mechanisms and rules [should] neither unfairly advantage nor disadvantage one provider over another, and neither unfairly favor nor disfavor one technology over another.”¹⁰ A necessary corollary is that all funding shall be disbursed in a portable manner: that is, universal service support follows the subscriber and is available to any designated ETC that provides service to the subscriber. The Commission specifically determined that this concept should also apply in areas served by rural carriers.¹¹

2. Key Decisions Regarding ETC Designation and Portability

In *Alenco Communications, Inc. v. FCC*,¹² the Fifth Circuit affirmed the FCC's decision to make universal service support portable, meaning that the support moves with the customer rather than remaining with the ILEC when the customer chooses to change carriers. The court found petitioners' contention that the portability of the support violated the statutory principle of sufficiency of universal service funding to be without merit, and instead concluded that the Act, as well as the principle of competitive neutrality, "dictate[]" portability.¹³ The court reasoned that the purpose of universal service is to benefit the customer, not the carrier; thus, "sufficient" funding of the customer's right to adequate telephone service can be achieved regardless of which carrier ultimately receives the payment.¹⁴ Significantly, the court also noted that "the FCC must see to it that both universal service and local competition are realized; one cannot be sacrificed in favor of the other."¹⁵ The decision also held that implicit cross-subsidies are prohibited by the Act.¹⁶

In the *Kansas Funding Preemption Order*,¹⁷ the FCC held that Kansas' original state universal service funding system, which provided substantially greater funding to ILECs than to competitive ETCs, would pose unlawful barriers to entry, and would have been subject to preemption.¹⁸ Fortunately, preemption was not needed because, after the preemption petition was filed, the Kansas Corporation Commission adopted new regulations for determining and allocating universal service support that made all support fully portable among competing carriers in Kansas.¹⁹ In its decision, the FCC stated that any similar non-competitively neutral state programs would likely run afoul of section 253 of the Act.²⁰

In the *South Dakota ETC Preemption Declaratory Ruling*,²¹ the FCC determined that requiring competitors to provide ubiquitous service prior to ETC designation is an unlawful barrier to entry.²² The ruling concerned a decision of the South Dakota Public Utilities Commission that had denied ETC designation on the grounds that the applicant was not providing service ubiquitously prior to designation.²³ The FCC held that, if the PUC decision had not already been reversed by a reviewing state court,²⁴ it would be subject to preemption under Section 253.²⁵

In *Comsat Corp. and AT&T Corp. v. FCC*,²⁶ the Fifth Circuit held that permitting implicit universal service support, and rate mechanisms that effectively create such support, violate Congress's clear directive that universal service support must be explicit. Specifically, the court held that the FCC decision to permit ILECs to continue to recover universal service costs through access charges to interexchange carriers constituted an unlawful violation of Section 254(e).²⁷ The

court expressly stated that the FCC cannot foster and maintain a universal service system based on any implicit support, whether on a permissive or mandatory basis.²⁸

3. Key Decisions Regarding Funding in Non-Rural Areas

The *Universal Service Ninth Report and Order*²⁹ established a federal high-cost universal service funding plan for non-rural carriers (e.g., the Bell companies, other large incumbents, and competitors in their service areas) based on a methodology using a forward-looking cost model. In order to determine how much money a state was entitled under the non-rural program, the order set a benchmark of 135% of national average forward-looking cost per line. If the average cost of service statewide exceeded this benchmark, the FCC would provide funding for costs exceeding the benchmark. The FCC also eliminated a “quirk” in its rules that had previously delayed funding to competitive ETCs, while providing funds promptly to incumbents.³⁰

In July 2001, the U.S. Court of Appeals for the Tenth Circuit reversed the *Ninth Report and Order* on the grounds that the agency did not provide “sufficient reasoning or record evidence” to support its actions. In *Qwest Corp. v. FCC*,³¹ the Tenth Circuit held that the FCC did not provide sufficient justification for the 135% benchmark it introduced in the *Ninth Report and Order*. The court also found that the non-rural program lacked sufficient “inducements” for states to establish intrastate mechanisms to support universal service.³² The court wrote: “The FCC may not simply assume that the states will act on their own to preserve and advance universal service. It remains obligated to create some inducement – a ‘carrot’ or a ‘stick,’ for example, or simply a binding cooperative agreement with the states – for the states to assist in implementing the goals of universal service.”³³ The court remanded the case to the FCC for further consideration, and did not address the petitioners’ contention that the actual level of funding produced by the program is too low to support universal service adequately.³⁴

In the May 2000 *CALLS Order*,³⁵ the FCC substantially reduced the implicit support that large ILECs recover through their access charges, and increased the subscriber line charge (“SLC”) paid by end users.³⁶ The FCC also created an explicit \$650 million fund to provide universal service support previously provided through the ILECs’ access charges.³⁷ This fund, known as Interstate Access Support, is provided on a per-line basis and is portable on a competitively neutral basis to any ETC serving a supported customer, regardless of the technology used by that carrier.³⁸

The Fifth Circuit Court of Appeals upheld most of the *CALLS Order* against a challenge spearheaded by telecommunications consumer advocacy groups.

In *Texas Office of Public Utility Counsel v. FCC*,³⁹ the Fifth Circuit noted that Section 254 of the Telecommunications Act of 1996 allowed the FCC to use its discretion to ensure affordable rates, and that the FCC had reasonably interpreted Section 254 in implementing most of its rule changes.⁴⁰ The court did, however, find that the FCC had failed to provide sufficient justification for certain elements of the CALLS order, including the \$650 million amount of the newly-established universal service subsidy fund.⁴¹ The court remanded these to the FCC with instructions to demonstrate a rational basis for the figures it chose.⁴²

4. Key Decisions Regarding Funding in Rural Areas

In its *Rural Task Force (RTF) Order*,⁴³ the FCC adopted, with minor modifications, the universal service recommendations submitted by the Rural Task Force (RTF), which had included representatives of a broad cross-section of carriers, including rural telephone companies, competitive local exchange carriers, long distance carriers, wireless providers, consumer advocates, and state regulators. In so doing, the FCC adopted the RTF's compromise between the rural telephone companies' desire to allow unrestrained growth in funding levels, and that of net contributors to the fund who sought to retain the existing cap on funding growth.⁴⁴ The *RTF Order* rebased high-cost loop support for rural carriers and retained a slightly modified version of the pre-existing indexed cap on fund growth.⁴⁵ Significantly, the RTF plan retained the principle that all funds disbursed to rural ILECs would be available on a fully portable basis to competitive ETCs operating in their areas.⁴⁶ The FCC adopted the RTF's recommendation that the plan remain in place for a five-year period, to ensure stability for the funding system in rural areas.⁴⁷

In its *Multi-Association Group (MAG) Order*,⁴⁸ the Commission adopted parts of a plan for universal service and interstate access charge reform submitted to the Commission in October 2000 by a group of ILEC associations. Among other things, the Commission adopted the MAG proposals to increase Subscriber Line Charge ("SLC") caps for rate-of-return carriers to the levels already established for price cap carriers, and significantly reduce the access charges paid by IXC's, which contained some implicit subsidies.⁴⁹ The *MAG Order* also established the Interstate Common Line Support ("ICLS") to replace those implicit subsidies with an explicit subsidy that would be portable to competitive ETCs.⁵⁰

III. Growth in the Federal High-Cost Universal Service Fund

The vast majority of the growth in the explicit federal high-cost universal service fund ("USF") over the past several years can be attributed to the changes adopted by the Commission in the *CALLS Order*, the *RTF Order*, and the *MAG Order*. The effect of these three orders – and not the growth of CETCs, as

some ILECs have alleged – are primarily responsible for a large preponderance of growth in the USF.

The *CALLS Order* established the Interstate Access Support (“IAS”) fund, which is annually sized at \$650 million, amounting to about **40.6%** of the total annual growth in the high-cost fund since 1999.⁵¹

The annual impact of the *MAG Order*, which created the Interstate Common Line Support (“ICLS”) fund, can be estimated based on annualizing the quarterly amount reported by USAC during second quarter 2003 (the most recently available time period) – \$383.5 million. This amounts to about **23.9%** of the total annual growth in the high-cost fund since 1999.

The effect of the *RTF Order* on the size of the Fund is somewhat more difficult to calculate because, rather than creating a new support mechanism, the *RTF Order* modified the methods of calculation that apply primarily to the High-Cost Loop (“HCL”) portion of the fund. Prior to the adoption of the *RTF Order*, the Rural Task Force reported an estimate of the impact of the order under which the overall size of the fund would increase by \$230.2 million annually during calendar year 2003, as compared with the result if the order had not been adopted.⁵² Thus, growth in the fund due to the policy changes in the *RTF Order* amounts to about **14.4%** of the total annual growth in the high-cost fund since 1999.

By contrast, as of the second quarter of 2003, USAC reports that CETCs were to receive approximately \$36.9 million, which, if annualized, results in an annual amount of approximately \$147.4 million. Thus, the annual growth of the fund attributable to CETC entry since 1999 amounts to only about **11.7%** of the overall growth of the fund during this time period.

These figures are displayed in the following table:

Policy Decision or Other Cause of Fund Growth	Annual Fund Growth (calendar year 1999 vs. 2Q’03 annualized)	Percent of Total Annual Growth in High-Cost Fund
CALLS (IAS)	\$650,000,000	40.6%
MAG (ICLS)	\$383,490,917	23.9%
RTF (amount for 2003, as estimated in 2000)	\$230,946,918	14.4%
[Other ILEC fund growth – unexplained]	\$191,480,842	11.9%
Total ILEC fund growth	\$1,455,218,677	90.8%
CETC funding	\$147,409,832	9.2%
Total fund growth	\$1,602,628,509	100.0%

Thus, at least 78.9% of the growth in high-cost support since 1999, and possibly as much as 90.8% of that growth, is attributable to policy changes that were sought by ILECs, that primarily benefited the ILECs, and that the Commission determined would be valuable and beneficial.⁵³ By contrast, only about 11.7% of the growth has any relationship to CETCs. Any attempt to blame overall growth on the entry of new CETCs to the market instead of on these overall increases in the USF, increases that were supported and advocated by the ILECs themselves, is inaccurate and should be dismissed.

ENDNOTES

1. *Federal-State Joint Board on Universal Service*, First Report and Order, 12 FCC Rcd 8776, 8890-93, ¶¶ 208-13 (1997) (“*Universal Service First Report and Order*”).
2. *Id.*
3. *Id.*
4. *Id.*
5. This concept remains in place today. See 47 U.S.C. § 254(g).
6. *Universal Service First Report and Order*, 12 FCC Rcd at 8890-92, ¶¶ 208-11.
7. *Id.* at 8892-93, ¶ 212.
8. *Id.* at 8952-60, ¶¶ 326-45.
9. 47 U.S.C. § 254.
10. *Universal Service First Report and Order*, 12 FCC Rcd at 8801-02, ¶ 47.
11. *Id.* at 8944, ¶ 311.
12. 201 F.3d 608 (5th Cir. 2000).
13. *Id.* at 622.
14. *Id.* at 621.
15. *Id.* at 615.
16. *Id.* at 616.
17. *Western Wireless Corporation Petition for Preemption of Statutes and Rules Regarding the Kansas State Universal Service Fund Pursuant to Section 253 of the Communications Act of 1934*, File No. CWD 98-90, Memorandum Opinion and Order, 15 FCC Rcd 16227 (2000).
18. *Id.* at 16231-33, ¶¶ 9-11.
19. *Id.* at 16230-31, ¶ 6.
20. *Id.* at 16232, ¶ 10.
21. *Federal-State Joint Board on Universal Service; Western Wireless Corporation Petition for Preemption of an Order of the South Dakota Public Utilities Commission*, CC Docket No. 96-45, 15 FCC Rcd 15168 (2000) (“*South Dakota ETC Preemption Declaratory Ruling*”).
22. *Id.* at 15172, ¶ 10.
23. *Id.* at 15169, ¶ 3.
24. *Id.*
25. *Id.* at 15172, ¶ 10.
26. 250 F.3d 931 (5th Cir. 2000).
27. *Id.* at 939-40.
28. *Id.* at 939.
29. *Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, Ninth Report and Order, 14 FCC Rcd 20432 (1999).

ENDNOTES (continued)

30. *Id.* at 20462-67, ¶¶ 53-63.
31. 258 F.3d 1191 (10th Cir. 2001).
32. *Id.* at 1202, 1204.
33. *Id.*
34. *Id.* at 1205.
35. *Access Charge Reform*, CC Docket No. 96-262, Sixth Report and Order, 15 FCC Rcd 12962 (2000) (“*CALLS Order*”), *aff’d in part, rev’d in part sub nom. Texas Office of Pub. Util. Counsel v. FCC*, 265 F.3d 313 (5th Cir. 2001).
36. *Id.* at 12974-75, 12977, ¶¶ 30, 35.
37. *Id.* at 13039, ¶ 186
38. *Id.*
39. 265 F.3d 313 (5th Cir. 2001).
40. *Id.* at 321, 329.
41. *Id.* at 327.
42. *Id.* at 329.
43. *Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, Fourteenth Report and Order and Twenty-Second Order on Reconsideration, *Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers*, CC Docket No. 00-256, Report and Order, 16 FCC Rcd 11244 (2001) (“*RTF Order*”).
44. *Id.* at 11247-48, ¶ 6.
45. *Id.* at 11249-50, ¶ 12.
46. *Id.* at 11314, ¶ 178.
47. *Id.* at 11248-49, ¶¶ 10-11.
48. *Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers*, 16 FCC Rcd 19613 (2001) (“*MAG Order*”), *recon.*, 17 FCC Rcd 11472 (2002).
49. *Id.* at 19621-22, ¶ 15.
50. *Id.*
51. The annual growth rate of each the fund components were converted into percentages by comparing them against the total size of the high-cost fund – \$1.602 billion, based on comparing the total size of the fund during second quarter 2003 (\$830.7 million), converted to an annualized amount (\$3.322 billion), versus the total size of the fund during calendar year 1999 (\$1.72 billion).
52. Letter from William R. Gillis, Chair, Rural Task Force, to Magalie Roman Salas, FCC, CC Docket No. 96-45 (Nov. 10, 2000), at Attachment 2; *see also RTF Order*, ¶ 28 & Separate Statement of Chairman Michael K. Powell.

ENDNOTES (continued)

53. It should be noted that CETCs receive a small proportion of the funding changes due to the CALLS, MAG, and RTF orders. Thus, there is a relatively small degree of overlap between certain of the rows in the table.